Oral Statement of Curtis L. Hage

Chairman of the
Council of Federal Home Loan Banks

Regarding H.R. 3703, The Housing Finance Regulatory Improvement Act of 2000

Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee of Banking and Financial Services

U.S. House of Representatives

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Good morning Chairman Baker, Congressman Kanjorski, Chairman Leach, Congressman LaFalce and Members of the Subcommittee. My name is Curt Hage and my bank, Home Federal Savings Bank of Sioux Falls, South Dakota, is one of the 74-hundred owner banks of the Federal Home Loan Bank system.

For disclosure purposes, I should mention that I wear several hats. I am a member of the Board of Directors of the Federal Home Loan Bank of Des Moines; the 2nd Vice Chair of America's Community Bankers; and serve as Chair of the Council of Federal Home Loan Banks. I am here today on behalf of the Council.

I am here to tell you that partnership with the Federal Home Loan Bank of Des Moines is very important to our bank's success. Moreover, our success is important to the 20 communities, small and large, that we serve in South Dakota.

Mr. Chairman and Congressman Kanjorski, I would like to take this opportunity to thank you both for the extraordinary effort you put forth to enact legislation to modernize the Federal Home Loan Bank system. Without your leadership and efforts, the Federal Home Loan Bank System Modernization Act of 1999 would not have come to fruition. That Act is substantial.

First, the legislation decentralized management of the Federal Home Loan Banks. Local governance decisions are most effective if made at the local level.

Second, "leveling the playing field" of membership status was an important and appreciated change.

Third, the addition of small business and farm loans as eligible collateral for smaller community financial institutions provides needed access to more funding.

Finally, thanks to this legislation, the capital structure of the Federal Home Loan Bank system is being revised for the first time in 68 years. This is an extremely important and dramatic revision. If carefully crafted with coordination and support from the Federal Home Loan Bank members, it can improve an already strong system.

Again, Mr. Chairman, we want to emphasize how constructive you were in the legislative process over the last several years and know that your intentions with H.R. 3703 are constructive as well. Your staff has remained in communication with our offices relative to our issues of concern. In fact, modifications suggested by your staff would significantly alter our areas of concern. If such modifications are adopted, I believe the Council of FHLBanks would not have objection to favorable consideration of H.R. 3703.

With that as the context, I would like to make three key points this morning and ask the Committee to reference my written testimony for the specifics on H.R. 3703.

The first point is that the Federal Home Loan Bank System is unique. It is a child of the depression, designed to partner with local financial institutions starved for liquidity and thus, unable to lend. The Federal Home Loan Banks' liquidity mandate is no less important today than it was 70 years ago. But now, in addition to being a vital tool for housing finance liquidity, they are also vital community lending and development tools.

In fact, Federal Home Loan Banks through their members build communities. Because of this important function and because our members' needs are growing, the Federal Home Loan Banks are growing. And they are growing in spite of the mutual fund explosion. The 1990s saw the mutual fund industry explode to over 7 trillion dollars. A great deal of that growth came from deposits in local banks. In spite of this massive deposit drain, banks and thrifts continue to provide credit to their communities, through the advances provided through the Federal Home Loan Banks. This dependable, low cost source of funds supports the continued lending role of community banks.

We note with great concern that after the last hearing you held on this subject, the rate spreads on GSE debt jumped substantially and our fund costs increased. Clearly, the Treasury line of credit needs to be handled cautiously.

My second key point today is that the Federal Home Loan Banks operate in a very safe and sound manner. We are subject to annual safety and soundness exams. We have, by regulation and practice, an extremely low tolerance for credit and interest rate risk. In fact, the system has never experienced a credit loss. Two reasons for that great track record are that the Federal Home Loan Bank advances are fully collateralized and we have statutory lien protections for that collateral. H.R. 3703 proposes removing this protection in Section 138. In our view, that removal would be problematic and serve no purpose.

Current law requires the Federal Home Loan Banks to secure their loans with specified collateral. Rather than identifying, assigning or perfecting that collateral, which would be a costly and time-consuming process, well-capitalized community banks and other portfolio lenders may use a blanket lien to cover their entire portfolio of eligible collateral. This is a practical and efficient way to hold down the cost of advances and the administrative burdens for the community bank, the consumer and the Federal Home Loan Bank.

Furthermore, in the event of a loss by a financial institution, the super lien -- like a perfected lien -- would have first claim on the failed bank's assets. Removing the super lien would not, as some purport, place the Federal Deposit Insurance Corporation in a better position in the event of a bank failure. Without the super lien the Federal Home Loan Banks would perfect their security interests and thus have a first claim on the assets.

Finally, the third point I want to make today is that the biggest job facing the Federal Home Loan Bank system is the daunting task of capital restructuring.

The sweeping capital changes brought by the Modernization Act require Federal Home Loan Banks to prepare and implement a new capital structure. Many complex issues and decisions need to be made and broadly understood to create a sound new permanent capital structure. Therefore, with all due respect, changing the regulatory of the Federal Home Loan Banks at this time would be most problematic.

We are concerned about the limitations Section 111, of H.R. 3703 would impose. We prefer assurances that limitations would not be arbitrary or counter to good safe and sound balance sheet management.

The Federal Home Loan Banks' loss-free record is due in great part to the flexibility that management has had historically to manage their balance sheets in difficult times. The housing finance market is cyclical, which means our advances business is also cyclical. Mortgage-backed securities (MBS) are a financial management tool that is low-risk and readily tradable commodity used by our members every day.

The Finance Board currently limits our purchase of MBS to three times capital. We believe that limitation is sufficient to focus the FHLBanks on their mission. We believe that the legislation should respect the need for flexibility, allowing MBS as a mission consistent tool, to assure safe and sound business management. Without a safe and sound balance sheet, *no advances* will be made, *no affordable housing grants* will be made and *no members* will join the system.

As we restructure our capital to provide for a strong and flexible FHLBank system, we envision a capital structure that will allow the FHLBanks to better meet the lending needs of the communities and customers we serve.

Mr. Chairman, that concludes my statement. I would be happy to address and questions the Committee may have.